Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:6 PLR-119807-98
Date:
MAR 26 1999

Legend:

X =

Y =

A =
B =

J =

M =
N =
O =

Dear

This letter refers to your ruling request dated March 2, 1998, amended on April 10, 1998, and March 15, 1999, concerning the effects of a proposed transaction under sections 1245 and 1250 of the Internal Revenue Code.

X, a corporation organized under the laws of the state of O, is recognized as exempt under section 501(c)(25) of the Code. X's sole property is rental income-producing real estate known as J located in the city of M, state of N (the "Property"). X collects the rental income paid by tenants of the Property and pays it over, net of expenses, to A on behalf of B. B is a governmental plan for a state's retired employees described in section 401(a) and exempt under section 501(a). A is a state instrumentality and is comprised of the Governor, Treasurer, and Comptroller of the state.

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A has determined that the form of ownership of the Property by X produces an unnecessary tax burden under the state laws of N and that the state tax reduces the benefits available to B's beneficiaries. The state of N imposes an initial franchise tax of 0.15 % and an annual franchise tax of 0.10% of the paid-in capital of X. A has determined that the state of N will not impose the franchise tax if the Property is held by a limited liability company.

A created Y as a limited liability company. Y filed its Certificate of Formation with the state of O's Division of Corporations. Y's Certificate of Formation and the accompanying Operating Agreement provide that Y was organized for the exclusive purposes of acquiring and holding title to real property, collecting income from the property, and remitting net income therefrom to one or more members of Y described in section 501(c)(25)(C) of the Code. Y's sole member is A on behalf of B. Y has been determined to be exempt under section 501(c)(25).

A proposes that X be merged with and into Y with Y as the surviving entity. Y will become the owner of the Property and will assume all responsibility for managing the Property and paying over the rental income, net of expenses, to A for the benefit of B.

In a letter dated October 31, 1977, the Internal Revenue Service determined that B is a qualified retirement plan described in section 401(a) of the Code and that B is exempt from federal income tax under section 501(a). In a letter dated May 11, 1998, the Service determined that X is exempt from income tax under section 501(a). In a letter dated July 9, 1998, the Service ruled that the statutory merger of X into Y will not adversely affect the status of Y as a title holding company described in section 501(c)(25) or result in the imposition on X or Y of any unrelated business income tax under sections 511 through 514.

X represents that it has always been exempt from federal income tax under section 501(a) of the Code.

X requests the Service to rule that the merger of X into Y would not result in the recognition of ordinary income by X under section 1245(a) or 1250(a) of the Code if X can establish by adequate records that the amount of depreciation or amortization allowed in computing unrelated business taxable income has always been zero.

Under sections 1245(a) and 1250(a) of the Code, certain gains on dispositions of depreciable or amortizable property are treated as ordinary income and recognized notwithstanding any other provision of Subtitle A (Income Taxes), including section 501(a).

If section 1245 property is disposed of, section 1245(a)(1) of the Code generally provides that the amount by which the lower of (A) the recomputed basis of the property or (B) the amount realized (in the case of a sale, exchange, or involuntary conversion) or the fair market value of the property (in the case of any other disposition), exceeds the adjusted basis of the property, is treated as ordinary income. This gain is recognized notwithstanding any other provision of Subtitle A.

The term "recomputed basis" is defined in section 1245(a)(2)(A) of the Code as meaning with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in the adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.

Section 1245(a)(2)(B) of the Code provides that for purposes of section 1245(a)(2)(A), if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

Section 1.1245-2(a)(8) of the Income Tax Regulations provides that in respect of property disposed of by an organization that is or was exempt from income taxes (within the meaning of section 501(a) of the Code), adjustments reflected in the adjusted basis (within the meaning of section 1.1245-2(a)(2)) include only depreciation or amortization allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a)), or (ii) in computing taxable income of the organization (or a predecessor organization) for a period during which it was not exempt or, by reason of the application of section 502, 503, or 504, was denied its exemption.

If section 1250 property is disposed of, section 1250(a)(1)(A) of the Code generally provides that the applicable percentage (as defined in section 1250(a)(1)(B)) of the lower of (i) that portion of the additional depreciation attributable to periods after December 31, 1975, in respect of the property, or (ii) the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion) or the fair market value of the property (in the case of any other disposition) over the adjusted basis of the property, is treated as gain that is ordinary income. This gain is recognized notwithstanding any other provision of Subtitle A.

The term "additional depreciation" is defined in section 1250(b)(1) of the Code as meaning, in the case of any property, the depreciation adjustments in respect of the property; except that, in the case of property held more than one year, as meaning the depreciation adjustments only to the extent that they exceed the amount of the

depreciation adjustments that would have resulted if the depreciation adjustments had been determined for each taxable year under the straight line method of adjustment.

The term "depreciation adjustments" is defined in section 1250(b)(3) of the Code as meaning, in respect of any property, all adjustments attributable to periods after December 31, 1963, reflected in the adjusted basis of such property on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for exhaustion, wear and tear, obsolescence, or amortization (other than amortization under section 168 (as in effect before its repeal by the Tax Reform Act of 1976), 169, 185, (as in effect before its repeal by the Tax Reform Act of 1986), 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, or 193). For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any period was less than the amount allowable, the amount taken into account for such period shall be the amount allowed.

Section 1.1250-2(d)(6) of the regulations provides that in respect of property disposed of by an organization that is or was exempt from income taxes (within the meaning of section 501(a) of the Code), the depreciation adjustment (reflected in the adjusted basis) referred to in section 1.1250-2(d)(1) includes only adjustments allowed or allowable (i) in computing unrelated business taxable income (as defined in section 512(a)), or (ii) in computing taxable income of the organization for a period during which it was not exempt or, by reason of section 502, 503, or 504, was denied its exemption.

Based solely on the representations and the relevant law and regulations set forth above, we conclude that the merger of X into Y will not result in the recognition of ordinary income by X under section 1245(a) or 1250(a) of the Code if X can establish by adequate records that the amount of depreciation or amortization allowed in computing unrelated business taxable income (as defined in section 512(a)) has always been zero.

Except as specifically ruled upon above, we express no opinion concerning the federal income tax consequences of the transaction described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

KATHLEEN REED
Senior Technician Reviewer, Branch 6
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

enclosure:
Copy for section 6110 purposes